Testimony to the Senate Education Committee on MPSERS
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The retirement benefits offered by the Michigan Public School Employees Retirement System are risky, expensive and likely unsustainable. But there is a way to meet all the promises that the state has made to employees while reforming the system to make it predictable, affordable and current. It’s tough to accomplish this in a defined-benefit system, so the state should close its plan to new members and instead offer them a defined-contribution plan. While there is concern about additional cash needed to convert to a defined-contribution retirement system, there are plenty of ways to mitigate that need and develop a stable system.

Michigan’s private-sector faced many of the same problems facing MPSERS and worked through them by converting the plans. Last fall, we used proprietary data from the human resources consulting firm Aon Hewitt to compare MPSERS' and MSERS' pension and retiree health care benefits to plans offered by 24 major Michigan businesses in 2010. We found that none of the private-sector employers offered new employees traditional defined-benefit pension plans like MPSERS', which provides public school employees with an annual retirement income based on their final pay. Only a quarter of the companies had any kind of defined-benefit pension plan available for new hires, and these were "cash balance" plans, which emphasize career earnings and tend to be less generous. All of them offered defined contribution plans to new members.

As you likely already know, the state employees’ pension system has been closed to new hires since 1997. And while there have been no reports showing significant difficulty in finding qualified employees after that change, the savings are definite. The defined contribution retirement benefits cost the state 6 percent of wages compared to 8.3 percent for defined-benefit members. The resulted in $31 million of savings last year, and increased savings are expected this year as more employees are covered under the new system.

But more importantly, it saved the state from racking up more unfunded liability. While the state’s system was fully funded in 1997, it no longer is. The state expects that it needs $3 billion to cover costs already accrued, and this would be higher if the state hadn’t closed the system.

Large unfunded pension liabilities already exist in MPSERS, and drove the costs from 10 percent of pay last year to 16 percent expected in the upcoming fiscal year. The unions representing these employees are now including the impact of this increased cost in rationales for more revenue.

While savings from closing the state employees' system were substantial, state officials argue that closing MPSERS pension benefits to new hires will result in three different kinds of costs: increased costs for defined contribution payments over "normal costs," increased costs to amortize the unfunded liability, and the administrative costs for developing a new system. But there are problems in this analysis.

First, the "normal cost" of pensions is not etched in stone. A decade ago it was 10 percent of payroll. Now it's down to 4 percent. A better, but still not accurate assessment of normal costs would be to take the average contribution rates for the past 15 years. That yields around a 10 percent employer cost, much more than the 6 percent it takes to fund the state's defined-contribution system.

As to the amortization payment, the state already plays loosely with pension funding rules. For instance, in the 2007 fiscal year, the state passed a law that ignored the required contribution calculations for that year and simply paid 4.5 percent of the unfunded liability.

More importantly, the problem of shifting accounting rules is small compared to the problems with the state's assumptions, which are simply not appropriate to ensure that funds are available as employees retire. For instance, the state is spreading unfunded liability costs over the next 28 years. That's a good assumption only if you expect employees to retire at 73. The state also assumes an 8 percent return on investment while private-sector pensions can only use 6 percent at the moment.

So the choice is to continue to operate a risky pension system or to be up front about providing the cash needed to fund the program under conservative assumptions. An increased amount of cash to catch up with the state's underfunding problems is prudent regardless of whether the state wants to keep an open pension system.

But increased cash requirements are a concern. There are some policy changes that can be explored in order to address the expected $200 million in extra cash needed.

For instance, most MPSERS members are required to make employee contributions. The latest actuary report shows that it is equivalent to around 5 percent of payroll. Instantly converting to a defined-contribution system would mean that most active members would get around a 5 percent wage increase. Using only half of that increase to make the amortization payments would result in adequate prefunding while giving most employees an automatic raise.

And while there are other options, here is another that I think is superior: benchmarking retiree health care benefits to private-sector averages and using some of the savings to catch up on unfunded liabilities.

The fiscal problems of pension benefits are small compared to those of retiree health care in MPSERS. Taxpayers are scheduled to pay further costs of $17 billion to $28 billion to provide MPSERS retiree health benefits, assuming that the state continues to offer these benefits at their current level.

Michigan’s private sector reformed these benefits a while ago. Only three of the 24 companies in our study offer employer-subsidized retiree health insurance coverage, as MPSERS and MSERS do.

Nationally, only 28 percent of large employers offer retiree health benefits to new hires, according to a survey from Mercer, an international human resources consulting firm.

Even public-sector members are scaling back these benefits. Michigan State University no longer provides this benefit to newly hired employees. According to the Citizens Research Council, one-third of Michigan counties have closed their retiree health care benefits.

The state’s obligations under current policies range up to $28 billion right now. With such a substantial price tag, the state should at least develop and publish long-term estimates about retiree health care obligations.

With all of the demands made on the state budget, the state should revisit the policy. As the recent Giddings ruling emphasized, the state has made no promise that coverage will continue, and the bills for providing the benefits are mounting. Legislators should decide on the most equitable way of benchmarking this benefit.

There should be three goals in retirement benefit reforms: making the benefits affordable, current and predictable in both retirement cash and health care benefits. There are options to do this while meeting all of the promises the state has made.